No. 92-1697

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1992

CHARLES A. DODGE AND
CHRISTINE Y. ROBERTS
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

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QUESTIONS PRESENTED

1. Have this Court's previously mandated procedural guidelines for the use and application of the burden of proof and presumption of correctness standards in Tax Court controversies been so abused by the IRS, and misapplied by the inferior federal courts, in this case, that this Court should use this case as a vehicle for further defining the IRS's proper use of the bank deposits method of determining a taxpayer's gross income, especially where the IRS's arbitrary actions have resulted in a "naked assessment" against Petitioner Roberts?

2. In a case of first impression in the interpretation of the federal tax law, did the lower courts err in partially upholding the IRS's denial of Petitioner Dodge's claim to the exclusionary tax benefits provided by Congress for the recipients of HIP insurance benefits, under 26 U.S.C. § 104(a)(3), where there is no sharply defined public policy that is being served by denying the taxpayer such benefits, and the burden of proof was erroneously placed upon Petitioner Dodge on this issue (even though the IRS's "litigating position" on this HIP benefit issue was a *new* issue, raised by the IRS only shortly before trial in the Tax Court)?

3. Though the circuit court found that the Petitioners had partially met the burden of proof placed upon them in this bank deposits reconstruction case, and therefore that court overturned several key factual findings of the Tax Court, as being clearly erroneous; did the circuit court err in failing to hold that the burden of proof shifted to the IRS to offer evidence of likely taxable sources for the remaining disputed deposits, when the Petitioners had identified nearly 90% of the deposits, the vast majority came from nontaxable sources, and the auditing revenue agent testified that he knew of only one taxable source for a small amount of the questioned deposits?

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REPLY BRIEF FOR PETITIONERS

In reply to the allegations and assertions contained in the Brief in Opposition filed in this case by the Solicitor General and personnel of the Tax Division of the Department of Justice, on behalf of the IRS, the Petitioners file this Reply Brief to address and to refute certain erroneous representations and innuendos left by the government's arguments, and especially to bring to the attention of the members of this Court the fact that the *new* litigating position adopted and asserted by the IRS in this case (with regard to the HIP insurance proceeds received by Petitioner Dodge in each of the four years in question) is a litigating position that clearly violates the standards established in the IRS's Chief Counsel's Manual (App. F, *infra*, p.1a). Such *new* litigating position is diametrically opposed to the published position taken in several of the IRS's published rulings, in violation of even the IRS's own "in-house" standards. [1] See Treasury Regulation on Income Tax §1.104-1(d); Rev. Rul. 58-602, 1958-2 Cum. Bull. 109; and Rev. Rul. 69-154, 1969-1 Cum. Bull. 146 (Pet. 22, ftnt. 13). This Reply Brief will be devoted strictly to a discussion of these matters raised in the IRS's Brief in Opposition.

1. **Government's Unsanctioned Litigating Position.** After the Petition for Certiorari was filed in this case, the undersigned counsel for the Petitioners first become aware of the existence of a Chief Counsel's Manual for the IRS, which Manual apparently contains rules and standards that must be followed by personnel of the various District Counsel's Offices in adopting litigating positions in all tax cases. In response to a written inquiry to the Office of the Chief Counsel of the IRS in Washington D.C., counsel for the Petitioners has been supplied with a portion of this Chief Counsel's Manual, which provides, in part, that the IRS will

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[1] Even the existence of a Chief Counsel's Manual for the IRS, and the particular provisions set forth in Appendix F, *infra*, 1a, were not known to the undersigned counsel for the Petitioners, until after the Joint Petition for Certiorari was filed with this Court in this proceeding. The Chief Counsel's Manual is *not* readily available to members of the bar or to the general public; it is not available at any IRS office in Arkansas; and it may be available here in Arkansas only on certain electronic legal research services.

not take a litigating position in court in a tax case that is contrary to a published IRS ruling. Particularly, ¶ (35)8(12)3(6) of this Manual (App. F, *infra*, 2a) provides in part --

> The position taken in all cases, whether in the field offices or in the National Office, must be in accord with the technical and litigating position of the Chief Counsel. *The Service position, as a general rule, is initially determined in the regulations and published rulings, and it is the role of the Litigation Division of the office to support such positions.* (Emphasis supplied)

Thus, it is the understanding of the counsel for the Petitioners that the IRS will *not* assert a litigating position in a Tax Court case that is contrary to a published position that the IRS has taken in one of its rulings. As noted in the Petitioners' Petition for Certiorari (22-24), the *new* litigating position taken by the IRS against Petitioner Dodge (i.e. the HIP insurance proceeds he received in these years do not qualify for the *exclusion from gross income* provided by 26 U.S.C. § 104(a)(3)) is not only a *new* litigating position (that was taken substantially after the Respondent's Answer was filed in this proceeding); it is one that is diametrically opposed to these published standards of the Chief Counsel's Office, especially since these are published revenue rulings of longstanding that are directly on point and are contrary to the IRS's *new* litigating position asserted here.

Though some five months have now passed since the Petition for Certiorari was filed in this case; and some five years have now passed since the IRS first asserted this *new* litigating position in this case; the IRS has *not* withdrawn or modified its published rulings of longstanding regarding the tax free treatment of amounts received from HIP insurance proceeds that are in *excess* of actual medical expenses incurred. Accordingly, for the additional reason that the government is asserting a litigating position in this case against Petitioner Dodge that is diametrically opposed to the taxing agency's published interpretative policy of longstanding; and such interpretive position has been asserted *only* against Petitioner

Dodge in this case (without such litigating position having been asserted in any other reported case, or published IRS ruling or regulation); the Court should grant the Petitioners' Petition for Certiorari and reverse this unfair and inequitable assertion of an unsanctioned litigating position by the IRS against one of the Petitioners in this case, when that position has *not* been asserted against any other taxpayer in the country.

2. ***New* Litigating Position.** The IRS asserts in its Brief in Opposition (Br. Opp. 10–12) that this Court's prior decisions [2] -- where it was held that deductions or exclusions provided by statute should not be denied, unless a "sharply defined" public policy is present -- are inapplicable here, is, at the very least, an erroneous statement of the IRS's initial litigating position in this case. Such assertion could possibly even be described as a deliberate attempt to simply "cover up" the litigating position asserted by the IRS only shortly before the trial was originally scheduled in this case. Before this Court, the present counsel for the IRS [3] erroneously argues (Br. Opp. 11, ftnt. 8) that the

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[2] *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Lily v. Commissioner*, 343 U.S. 90 (1952); *Commissioner v. Sullivan*, 356 U.S. 27 (1958); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958); and *Hoover Motor Express Co. v. United States*, 356 U.S. 38 (1958).

[3] Before the Eighth Circuit, and in this Court, the IRS has been represented by attorneys of the Appellate Division of the Tax Division of the Department of Justice. In the Tax Court proceeding, the IRS was represented by attorneys of the Office of the District Counsel in Nashville, Tennessee. The *new* litigating position asserted by the IRS on September 8, 1988, regarding the agency's interpretation of 26 U.S.C. § 104(a)(3), was asserted as a matter of "public policy" by the IRS's counsel. *All* of the cases cited in footnote 2, *supra*, were cited and argued by the IRS's own counsel as being applicable to this *new* litigating position on the HIP insurance proceeds issue. The burden of proof and presumption of correctness standards (relied on by the government's counsel in this Court) were *not* argued at all by the IRS's counsel before the Tax Court, as these standards might apply to the HIP insurance proceeds issue. See, Brief for Respondent and Reply Brief for Respondent filed in *Dodge and Roberts v. Commissioner*, Docket No. 9830–87, that were filed with the Clerk of the United States Tax Court. It was *only* after Judge Swift's Opinion in the Tax Court was rendered on a "burden

assertion of the *new* litigating position by the IRS with regard to 26 U.S.C. §104(a)(3) was *not* raised as a "new matter" (as that term is used in Rule 142(a) of the Rules of the United States Tax Court), but, instead, was a mere *refinement* of the IRS's original position. In fact, the IRS's present counsel even attempts to assert that this litigating position was first raised by the Petitioners in their Tax Court Petition. Such assertions by the government do *not* correctly reflect the status of the record in this case.

The auditing Revenue Agent testified that he merely added up all the deposits to the Petitioners' joint and separate bank accounts; he asserted that *all* such deposits were income to *both* Petitioners: and he inconsistently proposed huge proposed deficiencies in income taxes and penalties against both Petitioners, based upon the same deposited items. Therefore, *any* legal or litigating position taken by the IRS on the tax treatment of the HIP insurance proceeds received by Petitioner Dodge would have to be considered a *refinement* of the government's position under the IRS's theory in this case. This is because the initial litigating position taken by the IRS was *so broad* that the IRS actually took no specific position at all on these HIP insurance proceeds (or any other of the Petitioners' deposits). Though the Petitioners generally asserted in their Petition that their bank deposits came from

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of proof" and "presumption of correctness" standard with regard to the HIP proceeds issue that the attorneys of the Appellate Section of the Tax Division of the Department of Justice abandoned the "public policy" arguments initially asserted by the IRS in support of its *new* litigating position, and the present legal position was adopted by the government's counsel, based solely upon the "burden of proof" and "presumption of correctness" standards that the government has asserted before the Eighth Circuit and before this Court. The Petitioners submit that the federal taxing agency has an obligation, especially in this case, to stand by its asserted litigating position that caused in this litigation in the first place, as opposed to adopting an *expedient* legal position (based upon burden of proof and presumption of correctness standards) in an attempt to uphold the Tax Court's decision, which opinion did not address the IRS's *new* litigating position on this HIP insurance proceeds issue. In this regard, the Petitioners submit that the IRS has a higher duty than normal litigants in adopting and maintaining its litigating positions, because such litigating positions should be applied to *all* taxpayers alike, not just to these Petitioners.

numerous nontaxable sources, including excluded insurance proceeds, the IRS did *not* assert the specific litigating position it adopted in this case (before the Tax Court and in its Tax Court briefs) in its Answer. Instead, the IRS simply alleged a general denial. It was not until September 8, 1988, when the IRS's counsel wrote to the Petitioners' counsel (more than 20 months after the IRS issued the Statutory Notice of Deficiency in this case) that this *new* litigating position was first asserted by the IRS in this case.

Under such circumstances, the assertion of this litigating position by the IRS raised a "new matter," as those terms are used in Rule 142(a) of the Rules of the United States Tax Court. It is *not* necessary for a litigating position to be raised *only* in the IRS's pleadings before it can be considered a "new matter." See, *Baird v. Commissioner*, 438 F.2d 490 (C.A.3, 1970); *Weinerskirch v. Commissioner*, 596 F.2d 358 (C.A.9, 1979); *Estate of Falese v. Commissioner*, 58 T.C. 895, 898–99 (1972); *Fitzpatrick v. Commissioner*, 37 T.C.M. 159, CCH T.C. Memo. 1978–27; *Florists' Transworld Delivery Assn. v. Commissioner*, 67 T.C. 333, 347–48 (1976); *Suarez v. Commissioner*, 61 T.C. 841 (1974); *Denman v. Commissioner*, 42 T.C.M. 249, CCH T.C. Memo. 1981–332; and *Zarin v. Commissioner*, 92 T.C. 1084, 1088–89 (1989).

Thus, the Petitioners assert that the "burden of proof" on the HIP insurance proceeds issue should have been properly placed upon the IRS by the Tax Court, as a "new matter" raised by the IRS; that the IRS's failure to produce *any* evidence to support its *new* litigating position on the HIP insurance proceeds issue is a fatal flaw in the government's case; and that this Court should grant the Petitioners' Petition for Certiorari and use this case as a vehicle for delineating a more "bright line" or "clear cut" standard with regard to the proper placement of the "burden of proof" on "new matters" raised by the IRS in Tax Court litigation, after the taxing agency's position has been asserted in its pleadings,[4] so that

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[4] The Petitioners assert that, since this is an action to assess a tax, not an action where the taxpayers are seeking a refund, the proper application of the "burden of proof" standards here will cause the proposed assessment to fail in this case, in its entirety, because the IRS has failed to offer *any* evidence in support

both the IRS and taxpayers will have a clearer view of where the burden of proof lies on an issue *not* raised by the IRS in its Notice or pleadings, but which is belatedly asserted at trial.

3. **Distorted Presentation of Controlling Facts.** The IRS has erroneously alleged (Br. Opp. 6–9) that the evidentiary record in this case establishes that the Service properly applied the bank deposits (indirect) method of reconstructing the Petitioners' income; that the usual "burden of proof" and "presumption of correctness" standards are applicable to this case (and, therefore, that the "naked assessment" exception is *not* applicable here); and that this case does not warrant review by the Court because it has been decided on a factual basis, so that there is no conflict with the Fifth Circuit decisions in *Portillo v. Commissioner*, 932 F.2d 1128 (C.A.5, 1991) and *Armes v. Commissioner*, 448 F.2d 972 (C.A.5, 1971). The Petitioners assert that the IRS's reliance, in its Brief in Opposition, upon a very, very, general discussion of the controlling facts; its erroneous assertion that the taxpayers produced no records relating to the nearly $700,000.00 deposited to their bank accounts during the four years in question; and that the Petitioners filed no tax return or returns reporting "minimal income;" together with the assertion that the IRS was aware that an "insurance speculation" scheme was present, are positions that are not well taken and are asserted only to support the IRS's claims of the applicability of the normal presumption of correctness standards in this case. The Petitioners submit that such assertions are not only erroneous; such broad and general allegations are asserted (after the fact) by the IRS in an effort to "bootstrap" the taxing agency into a position of legitimacy; when, in reality, the detailed and voluminous facts of this case clearly establish that the IRS abused its assessment power and has, therefore, made the Petitioners (especially Ms. Roberts) "victims of the system" for the following reasons:

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of its *new* litigating position. See, *Helvering v. Taylor*, 293 U.S. 507 (1935); *Commissioner v. Riss*, 374 F.2d 161 (C.A.8, 1967) and *Ehler v. Vinal*, 382 F.2d 58, 65–66 (C.A.8, 1967). Therefore, the proposed deficiency against Petitioner Dodge that is based upon this HIP insurance proceeds issue should be abated, in its entirety.

a. **Bank Deposits Method Improperly Used.** Though it is unquestioned by Petitioners that there was nearly $700,000.00 deposited to their joint and separate bank accounts in the four year period of time involved in this case, they assert that the IRS did *not* properly apply the bank deposits (indirect) method of proof, because the Revenue Agent totally failed to establish the three requirements that the courts have mandated for the IRS's use of such indirect method of reconstructing a taxpayer's income. See, *Gleckman v. United States*, 80 F.2d 349 (C.A.8, 1935), *cert. denied*, 297 U.S. 709 (1936), and the arguments previously asserted by the Petitioners (Pet. 20–21). Though there was nearly $700,000.00 deposited into these bank accounts in these four years, Revenue Agent Westbrook testified that his examination had disclosed that the *only* taxable source for any of these deposits was the "net profit" realized from the Petitioners' sporadic sales of autos and jewelry. As reflected in Appendix E, Table 3 (Pet.), there was *no* income from these sources for the Petitioners in 1981; only $1,200.00 in 1982; $8,300.00 in 1983; and $1,800.00 in 1984. [5] Thus, the "net profits" from these sources for *all* four tax years represents only 1.6% of the total of $700,000.00 in deposits. Such minute amount cannot be relied upon by the IRS as a basis for asserting that the Revenue Agent's actions were proper with regard to the remaining 98.4% of these deposits.

The IRS stipulated that more than $190,000.00 in questioned deposits came from nontaxable sources or from sources that had already been reported by Ms. Roberts. (Categories 4 and 5, App. E, Table 1, Pet. 40a), and that such deposits were from *nontaxable* sources (such as bank transfers, loan repayments, etc.). The stipulated Category 1, Insurance Proceeds, contained more than $257,000.00 of identified deposits (with many of the Unidentified Deposits in Category 2 alone probably being from this same

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[5] In accordance with Judge Swift's Opinion in the Tax Court, 50% of these amounts each year were attributable to each of the Petitioners. There were no amounts deducted from these "net profits" for expenses and costs incurred by the Petitioners for normally deductible expense they incurred in realizing such "net profits," and, in fact, they referred to these sporadic sales activities as a "hobby."

source). The IRS's assertion that these HIP insurance proceeds represented a "taxable source" was *not* asserted by Revenue Agent Westbrook or the IRS when the Statutory Notices of Deficiency were issued to the Petitioners, or when the Respondents' Answer was filed in the Tax Court. Instead, the IRS did not even assert that the $257,000.00 in HIP insurance proceeds (which amounts were identified by the Petitioners and personnel of the Appellate Division of the IRS in pretrial review, while this matter was before the Tax Court), were a "taxable source," until September 8, 1988, when the IRS first asserted its *new* litigating position with regard to § 104(a)(3). Thus, the IRS must not be allowed to "pull itself up by its own petard" and attempt to "bootstrap" itself into a position where it can claim a legitimate use of the bank deposits method of reconstructing income.

b. Burden of Proof Shifted. The opinions of the Tax Court and the Eighth Circuit in this case have eliminated substantially more than another $100,000.00 in Category 3, Miscellaneous – Identified, from the amounts that the IRS originally asserted were taxable income of the Petitioners. The evidence in this case establishes that the vast bulk of the $93,000.00 in Category 2 – Unidentified, was probably deposits attributable to the Boatman's Bank account where most of the HIP insurance proceeds were first deposited. Thus, if the HIP insurance proceeds are held to be *excluded* from income (as claimed by the Petitioners), pursuant to the provisions of 26 U.S.C. § 104(a)(3), then there remain only a few thousand dollars in Unidentified or Miscellaneous Identified deposits in Categories 2 and 3 that would still be in dispute between the parties.

The inconsistent treatment by the IRS, the Tax Court and the Eighth Circuit of the amounts in Categories 2 and 3 that were deposited into the one separate bank account maintained by Petitioner Roberts (when *all* other such Category 2 and 3 deposits were attributable to Petitioner Dodge by the lower courts) places Petitioner Roberts in the untenable position of having more than $30,000.00 worth of taxable income attributed to her by the application of the normal "burden of proof" and "presumption of correctness" standards applicable to tax cases, without the IRS ever

having reviewed her individual records; and there is no showing that Ms. Roberts possibly had income in these amounts from her taxable sources. It is also undisputed that Ms. Roberts reported *all* of her taxable income in each year (though it may have been *minimal*) on her timely filed income tax returns (which returns all reflected *no tax due*). Therefore, Petitioner Roberts pleads with the members of this Court to hold that she should *not* be treated so oppressively by the "system," when she has attempted in every way to comply with the tax reporting requirements of the Internal Revenue Code, without the IRS being required to assume the burden of proof on these issues, not just rely upon the normal "presumption of correctness" to sustain even the last 5% of its proposed assessment against her.

Petitioners submit that the IRS's citation to the Ninth Circuit's decisions in *United States v. Stonehill*, 702 F.2d 1288 (C.A.9, 1983), *cert. denied*, 465 U.S. 1079 (1984) and *Delaney v. Commissioner*, 743 F.2d 630 (C.A.9, 1984); the Tenth Circuit's decision in *Erickson v. Commissioner*, 937 F.2d 1548 (C.A.10, 1991); and the Second Circuit's decision in *Zeeman v. United States*, 395 F.2d 861 (C.A.2, 1968), are not well taken, since those cases are clearly distinguishable on their faces from the facts established by the Petitioners in this case. The decision of the two courts below in this case are inconsistent with, and in conflict with, this Court's guidelines for the proper application of the burden of proof and presumption of correctness standards, [6] and they are clearly in conflict with the decisions of the Fifth Circuit in *Portillo*, *supra*, and *Armes*, *supra*. The IRS must not be allowed to abuse the vast powers granted to it by Congress in the statutory scheme created for the tax assessment system without having some obligation to offer direct proof to sustain its arbitrary determinations in this type of case.

Therefore, this Court should grant the Petition for Certiorari and hold that, in these types of circumstances, the burden of

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[6] See, *Helvering v. Taylor*, 293 U.S. 507 (1935) and *United States v. Janis*, 482 U.S. 433 (1976).

proof shifts to the IRS when the taxpayers have offered credible evidence to support their position, and that the IRS rests, at its peril, *only* when it relied upon the "presumption of correctness" usually accorded its determinations to sustain its proposed assessment.

CONCLUSION

For the additional reasons set forth in this Reply Brief, the Petitioners submit that the members of this Court should grant their Joint Petition for Certiorari, and should use this case as a vehicle to further delineate the proper standards to be applied by the IRS in the use of the bank deposits (indirect) method of proof; the proper application of the burden of proof and presumption of correctness standards in tax cases; as well as to reject the "public policy" based argument originally asserted by the IRS for disallowing Petitioner Dodge the statutory right to exclude the HIP insurance proceeds he received from his gross income, in accordance with the clear intent of Congress as expressed in the unambiguous wording of 26 U.S.C. § 104(a)(3).

Respectfully submitted,

SEPTEMBER 24, 1993

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APPENDIX F

PORTION OF THE CHIEF COUNSEL'S MANUAL
(Department of the Treasury, Internal Revenue Service)

Paragraph (35)8(12)3 ***(9-5-89)***

Determination of Service Position

(1) It is incumbent upon all attorneys in this Office to ascertain what published rulings and regulations are involved in cases handled by them and to follow them unless given specific authority to disregard them, and to mention them in all actions on decision concerning such cases.

(2) All attorneys must ascertain not only rulings and regulations but also any issued documents from the National Office establishing the interpretation and litigation position of the Chief Counsel, as well as the administrative position of the Commissioner. Field attorneys and their supervisors are responsible for compliance with these requirements to the extent that the source of the material is available in the Region.

(3) It is important that positions taken in all briefs in the Tax Court, defense or suit letters for District Court and Claims Court cases, actions on decision, etc., correctly reflect Service position, and that they should not be at variance with outstanding regulations, rulings, acquiescences and nonacquiescences. It is also important that the development of regulations and rulings take proper cognizance of court decisions and pending litigation which may affect or be affected by such regulations and rulings. It must be remembered, however, that a ruling, regulation, etc., which applies a principle on the basis of a particular set of facts may or may not represent a position which should be applied broadly, or in a different factual situation, and that the final decision as to the litigation position to be followed in cases not clearly covered by

existing rulings, etc. remains with the National Office. Thus, the National Office may, as a matter of discretion, overrule or revise arguments advanced by the field in situations not clearly covered by existing rulings or interpretations, etc.

(4) Anything signed or approved by or in the name of the Chief Counsel should represent the position of the entire office and not merely the position of a particular division or part of the office.

(5) In cases involving important issues in which the litigation position of the Service has not been fully or clearly decided, the determination of the litigation position should be made after coordination among the various divisions. Coordination is required not only between the National and field offices, but also between the litigation and technical divisions of the National Office. If the field office deems it inadvisable to litigate an issue in accord with the Service position, the field office should submit the case to Assistant Chief Counsel (Tax Litigation) for tax litigation advice.

(6) The position taken in all cases, whether in the field offices or in the National Office, must be in accord with the technical and litigation position of the Chief Counsel. The Service position, as a general rule, is initially determined in the regulations and published rulings, and it is the role of the litigation divisions of the office to support such positions. Moreover, there may be instances in which it is determined not to specifically follow the regulations or published rulings. In this instance such determination may not be made by the Regional Counsel, or delegate, but can only be made by National Office officials.

(7) Attorneys are expected to utilize fully all available research materials. For field attorneys, if after having examined and considered all available research material there is still uncertainty as to the Service position on the issue, the Regional Counsel, or delegate, should request advice from the Assistant Chief Counsel (Tax Litigation).

(8) Except as may be specifically authorized by duly delegated officials, the position taken by the attorney at each stage of the handling and processing of a case must be in accord with the litigation and settlement position of the Chief Counsel. This is applicable to the settlement, trial and other processing of cases by field attorneys, the review of briefs and actions on decision in the National Office, and in any recommendation to the Department of Justice with regard to any case in litigation.